No. 2684

IN THE

# United States Circuit Court of Appeals

## For the Ninth Circuit

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MERCHANTS NATIONAL BANK OF SAN FRANCISCO (a corporation),

*Petitioner,*

vs.

THE CONTINENTAL BUILDING AND LOAN ASSOCIATION (a corporation) et al.,

*Respondents,*

In the Matter of Continental Building and Loan Association, Bankrupt.

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## BRIEF FOR APPELLANT AND PETITIONER.



R. P. HENSHALL,

*Attorney for Appellant and Petitioner.*

*Filed this..........................................day of March, 1916.*

*FRANK D. MONCKTON, Clerk.*

*By..........................................................................Deputy Clerk.*

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In the Matter of Continental Building and Loan Association, Bankrupt.

## BRIEF FOR APPELLANT AND PETITIONER.

### Statement of the Case.

This is a petition to revise, in matter of law, an order of the United States District Court, Northern District of California, confirming a ruling of the referee in bankruptcy, denying an application by the Merchants National Bank that it be permitted to vote as a creditor for the office of trustee of the bankrupt, and that all other persons, claiming to be

creditors, who are stockholders of the bankrupt, be denied the right to vote. The petition is taken under §24b of the Bankruptcy Act; but as there is some question whether the order is not appealable under §24a, §25a, an appeal was also perfected, in accordance with those sections.

The facts of the case are as follows: On August 9, 1915, the Continental Building and Loan Association was adjudged a bankrupt in the court below. On that day all further proceedings in the matter were referred to the referee in bankruptcy for the proper district, Hon. Armand B. Kreft. The petitioner and appellant is a national bank, and held a claim against the bankrupt, unsecured, based on a promissory note for $2,511.20, on account of money loaned (p. 2). This claim was presented, filed, proved and allowed by the referee (p. 3); and a proxy in due form was executed authorizing its attorney to vote the claim at any meeting held for the election of a trustee (p. 3).

On September 15, 1915 (p. 4), the first meeting of creditors of the bankrupt was held before the referee, at which meeting the appellant and petitioner attempted to vote its claim. At this meeting the only other creditor of the bankrupt present was the Pacific Gas and Electric Co. All the other persons present, claiming to be creditors, were stockholders and members of the bankrupt and their claims to be creditors arose out of their ownership of the stock of the bankrupt and not otherwise (p. 4). The Continental Building and Loan Associa-

tion is a building and loan association organized pursuant to the provisions of Part VI, Title XVI, of the Civil Code of California, and is a mutual corporation; and all such persons were stockholders or members of it, as required by law.

At the meeting referred to the appellant moved the referee that any and all claimants, who were stockholders or members of the association-bankrupt, be denied the right to vote (p. 4-5), upon the ground that they were not creditors within the meaning of the bankrupt law, and held no provable claims as such. The referee ruled that each such stockholder or member had the right to vote, and, furthermore, refused appellant and petitioner the right to vote as a creditor at all (p. 5-6).

The appellant and petitioner excepted to this ruling and brought it before the District Court on review, where it was affirmed (p. 59). The opinion of the District Court is in the record (id.). From this order the case comes up to this court for determination.

The assignments of error (p. 63), both on the appeal and in the petition (p. 27), raise substantially the same question, which is one of law,—Are the shareholders of a building and loan association creditors of a bankrupt building and loan association, by reason of their ownership of stock in it, as they hold provable claims entitling them to vote for the office of trustee within the meaning of the bankruptcy act? The specific specifications in that regard are as follows:

## Assignment of Errors.

*In the District Court of the United States, in and for the Northern District of California, First Division*

No. 9509

In the Matter of
CONTINENTAL BUILDING AND LOAN ASSOCIATION,
In Bankruptcy.

ASSIGNMENT OF ERRORS.

Now comes petitioner and appellant herein, Merchants National Bank of San Francisco, and files the following assignment of errors upon which it will rely upon its appeal from the order made by this honorable court on the 9th day of November, 1915, in the above-entitled cause, as follows:

I.

Said referee and said District Court erred in holding that your petitioner was not the only creditor present who was entitled to vote for the office of trustee.

II.

Said referee and said District Court erred in denying the motion of your petitioner that no other persons present, other than your petitioner, be allowed to vote for the office of trustee.

III.

Said referee and said District Court erred in allowing persons claiming to be creditors of said

bankrupt, who were stockholders and members thereof, to vote for the office of trustee of said bankrupt corporation.

IV.

Said referee and said District Court erred in excluding your petitioner herein from its right to vote for the office of said trustee.

V.

Said District Court erred in deciding that it was unnecessary to definitely determine at this time whether the shareholders of said Continental Building and Loan Association were creditors.

VI.

Said District Court erred in holding that the alleged bankrupt could, by naming its shareholders in its petition in voluntary bankruptcy, establish or create their status as creditors of the association.

Wherefore, by reason of the errors assigned, appellant prays that said order of November 9th, 1915, be reversed and that such further proceedings be had thereon according to law.

R. P. Henshall,
Attorney for Petitioner and Appellant,
Merchants National Bank of San Francisco.

(Endorsed): Presented in open court and filed Nov. 19, 1915, at 10 o'clock and 30 min. A. M. W. B. Maling, Clerk. By Lyle S. Morris, Deputy Clerk.

The case presents an interesting, as well as an important question of law under the Bankrupt Act, as noted by the lower court when it said that "the question as to whether the shareholders can be at the same time creditors is an interesting one" (p. 60). The order sought to be reviewed here should be reversed for the following reasons:

I. A shareholder of a corporation is a distributee of its assets, after all claims against the corporation are paid, and it is legally impossible for such a shareholder, pursuant to the transaction by virtue of which he becomes a shareholder, to be a creditor of the corporation, within the meaning of the bankrupt act.

II. No person can vote for the office of trustee unless he has a provable claim against the bankrupt; and shareholders of a corporation do not possess, by virtue of their shareholdings, provable claims against the bankrupt within the meaning of the bankrupt act.

III. The fact that the assets to be administered upon in the bankrupt court greatly exceed the value of the provable claims against the bankrupt, does not deprive the only creditors who have provable claims from electing a trustee for the bankrupt, and administering upon his estate until they are paid.

IV. The decisions of the courts are uniformly to the effect that stockholders in a building and loan association are not creditors.

## I.

**A SHAREHOLDER OF A CORPORATION IS A DISTRIBUTEE OF ITS ASSETS, AFTER ALL CLAIMS AGAINST THE CORPORATION ARE PAID, AND IT IS LEGALLY IMPOSSIBLE FOR SUCH A SHAREHOLDER, PURSUANT TO THE TRANSACTION BY VIRTUE OF WHICH HE BECOMES A SHAREHOLDER, TO BE A CREDITOR OF THE CORPORATION, WITHIN THE MEANING OF THE BANKRUPT ACT.**

The proposition of law contained in the foregoing point is self-evident and we suppose will not be disputed, but a word of explanation may not be inappropriate. Stockholders of a corporation are not creditors of the corporation any more than is an heir of a decedent a creditor of his estate, though both may possess enforceable obligations. The relation of debtor and creditor is limited in its legal definition, and does not include a relation which merely establishes the right to some remedy to enforce an obligation from one person to another. In its use in bankruptcy it is specially defined, as we shall hereafter show.

A stockholders of a corporation is not a creditor of it, within either the meaning of the Bankrupt Act or within the general acceptation of the term "debtor" and "creditor"; *he is a mere distributee of its assets after the prior payment of debts to creditors.* In other words, he is entirely without any claim whatever until the creditors are paid, and it is in consequence, a contradiction of the premises on which his relations to the corporation is founded, to speak of him as a creditor of the corporation. It is well established law that shareholders of a corporation are not creditors but merely distributees

thereof. Even preferred or guaranteed shareholders are not such creditors, and *afortiori* ordinary shareholders could not be so.

See

*4 Thompson on Corporations,* § 3607, §3608;
*Miller v. Ratterman,* 24 N. E. 496;
*Heller v. Nat'l Bank,* 89 Ind. 603; 45 L. R. A. 438;
*Mercantile Trust Co. v. Baltimore & Ohio R. R.,* 82 Fed. 360;
*Nickols v. New York, etc., R. R. Co.,* 15 Fed. 575.

The latter case is approved on this point though reversed on others in 119 U. S. 296.

In *Warren v. King,* 108 U. S. 398, 399, it was said:

A person *"cannot be both creditor and debtor by virtue of his ownership of stock."*

The only sense in which a stockholder of a corporation may be said to be (and then erroneously) a creditor was pointed out by the late A. C. Freeman in a note to *Heller v. National Bank* in 73 Am. State Rept. 213, in which he said:

> "There is one sense in which stockholders, common as well as preferred, are creditors. It is in the sense that corporations include all its capital stock among its liabilities, but it is a liability which is postponed to every other liability. * * * In the ordinary sense, however, a stockholder can not be a creditor of the corporation by virtue of his ownership of stock." Citing Belfast, etc., R. R. v. Belfast, 77 Maine 445.

In the present case, all of the stockholders of the alleged bankrupt sought to vote as creditors, and their claim to be such creditors *arose out of their ownership of stock and not otherwise,* and in the sense used by Mr. Freeman in the quotation just given, they are creditors. But they are not creditors in the general acceptation of the term, and particularly are not such within the meaning of the Bankrupt Act, and it is respectfully submitted that the conclusion of the referee and of the District Court to the contrary in that respect was clearly erroneous.

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## II.

NO PERSON CAN VOTE FOR THE OFFICE OF TRUSTEE UNLESS HE HAS A PROVABLE CLAIM AGAINST THE BANKRUPT; AND SHAREHOLDERS OF A CORPORATION DO NOT POSSESS, BY VIRTUE OF THEIR SHAREHOLDINGS, PROVABLE CLAIMS AGAINST THE CORPORATION WITHIN THE MEANING OF THE BANKRUPT ACT.

1. Under the Bankrupt Act no person, even though he may be at common law a creditor of the bankrupt, may vote for the office of trustee unless he possess a provable claim. The Bankrupt Act is quite specific on this point. Provable claims are specified in §63 of the act, and in subdivision "b" of §59 it is provided "That three or more creditors who have provable claims" may file an involuntary petition. In order, therefore, for a creditor to vote for the office of trustee, he must possess a claim which would entitle him to file an involuntary petition. Under §63 there are four classes of provable

claims. The first subdivision relates to fixed liabilities, the second and third to claims for taxable costs, the fourth subdivision refers to debts founded upon an open contract or upon a contract express or implied; the fifth and last refers to provable claims reduced to judgment after the filing of the petition.

Now if the stockholders of a corporation—bankrupt—are to be regarded as creditors holding provable claims, it must be under either subdivisions one or four just cited. And it should never be forgotten that it has been decided by the ultimate authority that the claims specified in subdivision four,—claims founded upon express or implied contracts,—must nevertheless be of the character of a fixed liability, as specified in subdivision one, at the commencement of the bankruptcy proceedings. This was directly adjudged in *Dunbar v. Dunbar,* 190 U. S. 340.

It follows, therefore, from this that provable claims under subdivisions one and four, meaning debts founded upon an open account, must possess a fixed liability at the time of the commencement of the bankruptcy proceedings.

Now it is clear than the claims of the stockholders against the corporation do not fall within this requirement of the statute, for *none of them can be regarded as a fixed liability at the time of the commencement of the proceedings.*

*Vide* Judge Gilbert's opinion in *Cohnan v. Wilhoft,* quoted *infra.*

Any liability that the corporation was under to its stockholders at the time of the commencement of the bankruptcy proceedings, under the authorities stated under Part I,—if a liability at all,—was one of a contingent character, and was not provable in bankruptcy.

It is well settled that contingent claims are not provable in bankruptcy.

*Dunbar v. Dunbar, supra;*
*In re Ells,* (D. C. Mass. 1900) 98 Fed. 967; 3 A. B. R. 564;
*In re Arnstein,* (S. D. N. Y. 1899) 101 Fed. 706; 4 A. B. R. 246;
*In re Mahler,* (E. D. Mich. 1900) 105 Fed. 428; 5 A. B. R. 457;
*In re Shaffer,* (D. C. Mass. 1903) 124 Fed. 111; 10 A. B. R. 633;
*Watson v. Merrill,* (C. C. A. 8th Cir. 1905) 136 Fed. 359; 14 A. B. R. 453;
*In re Ellis,* (C. C. A. 6th Cir. 1906) 143 Fed. 103; 16 A. B. R. 221;
*In re Imperial Brewing Co.,* (W. D. Mo. 1906) 143 Fed. 579; 16 A. B. R. 110;
*In re Pittsburg Drug Co.,* (W. D. Pa. 1908) 164 Fed. 482; 20 A. B. R. 227;
*In re Collignon,* (N. D. N. Y. 1900) 4 A. B. R. 250;
*Clemmons v. Brinn,* (N. Y. 1901) 7 A. B. R. 714;
*Evans v. Lincoln Co.,* (1903) 10 A. B. R. 401, 204 Pa. St. 448, 54 Atl. 321.

The distinction in this regard is, we think, well illustrated by the problems which arise under renting contracts. Rent due at the time of the filing of the petition constitutes a provable claim, but rent to become due, cannot be proved for the reason that it was not, when the bankruptcy occurred, a fixed liability.

Sec. 59, subd. "b."

> *In re Jefferson,* (D. C. Ky. 1899) 93 Fed. 948;
> *In re Ells,* (D. C. Mass. 1900) 98 Fed. 967; 3 A. B. R. 546;
> *In re Arnstein,* (S. D. N. Y. 1899) 101 Fed. 706;
> *In re Mahler,* (E. D. Mich. 1900) 105 Fed. 428;
> *Atkins v. Wilcox,* (5th Cir. 1900) 105 Fed. 595, 44 C. C. A. 628, 53 L. R. A. 118;
> *Wilson v. Pennsylvania Trust Co.,* (C. C. A. 3d Cir. 1902) 114 Fed. 742.

It is clear that the liability of the corporation here to its stockholders, is wholly of a contingent character. The amount of that liability is not capable of definite ascertainment. Like the annuity involved in the case of *Dunbar v. Dunbar, supra,* the actual value of what is due at the present time, can not be determined, and this is particularly so by virtue of the mutual character of the concern and the quasi-partnership relations existing between the stockholders. Such liability is simply the continuing obligation of the company to perform its contract which may result in the future in a liability

*in a definite amount,* becoming fixed upon some condition which may or may not be performed, taking place,—the commonest form of a contingent liability.

The decision of this court in the recent case of *Colman v. Withoft,* 195 Fed. 205, so fully covers and exhausts this whole subject that it is deemed advisable by us to quote the opinion in full, especially in view of the fact that it bears upon some other branches of the case. The opinion of Judge Gilbert is as follows:

> "The date of filing this petition in bankruptcy is intended to mark the line of separation between debts that are provable and those that are not provable against the bankrupt's estate. Those that are not provable remain subsisting obligations of the bankrupt, and he is not released therefrom by his discharge. The adjudication of bankruptcy does not dissolve contractual relations between the bankrupt and others. It takes from him his property and devotes it to the payment of debts which are provable under sections 63a and 63b of the bankruptcy act, but it does not absolve him from the obligations of contracts. Remington on Bankruptcy, Sec. 2729, and cases there cited.
>
> "While a contract to pay rent under a lease is not terminated by bankruptcy, the rent thereafter to accrue is not a provable debt against the estate. Watson v. Merrill, 136 Fed. 359, 69 C. C. A. 185, 69 L. R. A. 719; In re Roth & Appel, 181 Fed. 667, 104 C. C. A. 649, 31 L. R. A. (N. S.) 270; Atkins v. Wilcox, 105 Fed. 595, 44 C. C. A. 626, 53 L. R. A. 118; In re Rubel et al (D. C.) 166 Fed. 131; Loveland on Bankruptcy (3rd Ed.) 365. But the claim of appellant in this case, although it had its origin in the obligation of the bankrupt to pay

rent which accrued after the filing of the petition, is not, as it is presented, a claim for rent; but it is one that arises out of the contract of two lessees, jointly liable for rent, whereby one thereof, the bankrupt, agreed to reimburse the other for all the payments which it might make in excess of one-half of the rental, and to pay it one-half of such sum as it might be required to pay in gross, not to exceed $100 per month for the unexpired term, to obtain a recission of the lease. Is such a claim provable against the estate?

"It is held by the decided weight of authority that subdivisions 1 and 4 of section 63a of the Bankruptcy Act, are in *pari materia,* and that the words 'absolutely owing at the time of the filing of the petition against him' are to be read into subdivision 4. In re Roth & Appell, 181 Fed. 667, 104 C. C. A. 649, 31 L. R. A. (N. S.) 270; In re Swift, 112 Fed. 315, 50 C. C. A. 264; In re Adams, (D. C.) 130 Fed. 381; In re Burka, (D. C.) 104 Fed. 326. It is apparent that the appellant's claim was not a debt due and owing at the time when the petition was filed, but that it was contingent; that is to say, all the facts necessary to be shown to establish the bankrupt's liability to the claimant had not occurred before the petition in bankruptcy was filed.

" 'Where a liability of the bankrupt is not fixed so that it can be liquidated by legal proceedings instituted at the time of bankruptcy, it is not a debt. It is deemed so far contingent that it cannot be proved in bankruptcy, nor is it released by the bankrupt's discharge. A sum of money payable upon a contingency is not provable because it does not become a debt until the contingency has happened.' Loveland on Bankruptcy (3d Ed.), 324."

In Dunbar v. Dunbar, 190 U. S. 340, 23 Sup. Ct. 757, 47 L. Ed. 1084, it is said:

> " 'We do not think that by the use of the language in section 63a, it was intended to permit proof of contingent debts or liabilities or demands, the valuation or estimation of which it was substantially impossible to prove.'
>
> "At the time when the petition was filed, not only was the bankrupt not indebted to the appellant, but it could not then be known that he ever would be indebted to it, either for money to be paid for rent or for money to be paid for the rescission of the lease. As far as the rent was concerned, there were the contingencies that the lessee might cancel the lease, or that the trustee in bankruptcy might elect to pay the rent, or that the appellant might fail to pay more than its half thereof. As to the agreement looking to a rescission of the lease, there were the contingencies that the agreement which was without consideration, might be revoked by either party thereto before it was acted upon, or that it might be impossible to secure rescission on the terms stipulated by the bankrupt.
>
> "The decision in re Bingham (D. C.), 94 Fed. 796, is in point. At the time of the filing of the petition in that case the bankrupt and one Hartshorn were jointly liable on a note to a bank, but as between themselves each owed one-half the amount due thereon. The bank proved its claim on the note, and the other party to the note thereafter took up the note and proved his claim against the estate. The court said:
>
> " 'The bankrupt was bound to save him harmless from this part of the debt, and has not done so; but the indebtedness has occurred since the filing of the petition, and until that time Hartshorn had no provable claim on that account. By this bankruptcy act all claims turn

on their status at the time of the filing of the petition.'

"An apparent exception to the rule that contingent claims may not be proved under section 63a is the case of an indorser of the commercial paper of a bankrupt not due at the time of the filing of the petition, but whose liability as indorser thereafter becomes fixed. Moch v. Market Street Bank, 107 Fed. 897, 47 C. C. A. 49; In re Semmer Glass Co., 135 Fed. 77, 67 C. C. A. 551; In re Smith (D. C.), 146 Fed. 923. But it may be doubted whether the liability of an indorser in that class of cases is in any true sense contingent. The extent of his liability is at all times known, for it is measured by the note itself. Upon the adjudication of bankruptcy it would seem that there is an end to the contingency that the bankrupt himself may pay the note, and that there remains between that date and the maturity of the indorser's liability nothing but a question of time. But in view of these decisions, they are not applicable to the present case, for here there was a contingency, not only as to the amount of the liability, but as to its existence. The order of the District Court is affirmed."

It is clear, we think, that within the controlling principle announced in the decision that the liability of a corporation to its stockholders is not fixed, and is not owing, within the meaning of the bankrupt act. It could not in consequence be a provable debt, and not being a provable debt, a stockholder is not a creditor and is not qualified to vote for a trustee.

2. The claims of the stockholders against a corporation upon its dissolution, whether that dissolution be voluntary or involuntary, through bank-

ruptcy or through a receiver, are such as give rise to questions cognizable only in a court of equity.

Now, a bankrupt court exercising powers in bankruptcy, has equitable powers, but the jurisdiction of the courts of equity, as such, has not been conferred upon courts of bankruptcy. It will not be pretended, for example, that a stockholder might go into a court of bankruptcy upon equitable principles and seek to wind up the corporate affairs. An example taken from the bankrupt act in dealing with the subject of partnership will illustrate this point. The bankrupt law provides a method for the payment, first, of the general creditors and for the liquidation of the claim of the various partners with each other, and against the fund, if there be any.

Section 5, f. g. and h.

From this, however, it could not be inferred that one of the partners having a claim against the partnership assets, will be a proper person to put the partnership into bankruptcy. Indeed, by inference it has been so held, where it has been determined that the inherent right of a solvent partner to close up the affairs of the bankrupt must be recognized by the court of bankruptcy.

See: *In re Junck,* 169 Fed. 481.

On the other hand, it is clear that the Bankrupt Act did not intend to interfere with the right of the partners to close up the partnership. The pendency of a suit for the dissolution of the partnership could not deprive the creditors of the right

to put the partnership into bankruptcy but the only persons vested with the right to obtain such an adjudication are the general creditors.

Under subdivision "f" of Section 5 the Court is authorized to distribute the partnership assets among the partners and if it were not for this direct provision in the Bankrupt Act, the court would have no authority whatever over the relations of the partners between themselves. It was doubtless deemed advisable by Congress to vest the bankruptcy court with authority to determine this non-bankrupt matter. In this particular instance and under a familiar rule the express grant of authority is an implied negation of the authority in all other instances.

3. Still another illustration fortifies our contention in this connection. The Bankrupt Act specifies numerous acts of bankruptcy for which the bankrupt could be put into insolvency. Among these are briefly stated the conveyance of property with intent to defraud creditors, without regard to even the actual insolvency of the bankrupt; admission of inability to pay debts; appointment of a receiver; suffering a preference to be made in favor of one creditor over another while insolvent, and other instances.

Now, none of these instances are or can be made applicable to the case of a stockholder of a corporation. How could a stockholder, for example, allege that the corporation had conveyed away its property with intent to defraud its stockholders,

*so as to give jurisdiction in bankruptcy?* Such an allegation would give a court of equity jurisdiction, but the question is, could it give jurisdiction to a court in bankruptcy? Would an allegation, that a corporation had conveyed its property to one of its stockholders in preference to the claims of other stockholders, vest a court in bankruptcy with jurisdiction of the case?

But the instance that is conclusive upon this point is as follows:

With the exception of the first subdivision all of the acts of bankruptcy, specified by Congress, are only acts of bankruptcy when the bankrupt is insolvent, and solvency is a complete defense to the application for an involuntary adjudication.

The insolvency referred to in the Bankrupt Act,—as it appears to be defined,—is its condition where its assets taken at a fair value do not equal its liabilities. Could a stockholder make the allegation that the corporation was insolvent because its assets, taken at a fair value, would not equal the par value of its stock? What would or could the form of this allegation be? The insolvency of a corporation, so far as its stockholders are concerned, is *sui generis,* and there is no analogy between its insolvency and the insolvency referred to in the Bankrupt Act. This confusion is a part of the error involved in the assumption that a stockholder can be a creditor and simply illustrates that it was not within the purview of Congress that stockholders should be allowed to put a corporation into

bankruptcy, that the bankrupt court should wind up a corporation for the benefit of its stockholders, or that the operation of the Bankrupt Act should be extended to those instances of corporate management which have always fallen within the province of the court of equity.

4. It is very plain that the Bankrupt Act was never intended to include the distribution of the assets of a corporation among its shareholders. This follows inevitably from the history of the act and from the language of Section 8, Art. I, of the Constitution, where Congress was given power to pass "uniform laws on the subject of bankruptcies." Bankruptcies were originally applied to traders only and it was at one time questioned in this country whether Congress could constitutionally extend the act to apply to others. This, however, is no longer an open question and it is now established law that Congress may enforce a uniform law on the subject of bankruptcies and so broaden the operation of that law as to include all classes of debtors and all classes of creditors. But it is equally clear that this broadening extension has never gone so far as to include the winding up of corporations in the interests of their shareholders and it would require some affirmative and specific legislation upon this point to confer jurisdiction upon the bankrupt court along such lines, assuming that such legislation were constitutional. That it has not done so is quite clear from the Bankrupt Act and that it has not done so in this instance is equally clear from the

opinion of the State Supreme Court on one branch of the litigation, heretofore had over this case. For the State Supreme Court has held, with respect to the present bankrupt, that the jurisdiction of the bankrupt court only extended to the instances clearly specified in the Bankrupt Act, and did not supersede a state legislation providing for the dissolution and winding up of the corporation upon other grounds. A portion of the Bankrupt Act, under the very line of reasoning ably set forth in the opinion of Mr. Justice Henshaw, could not apply to a controversy between the corporation and its stockholders.

See *Cont. B. & L. Ass'n v. Superior Court*, — Cal —.

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## III.

THE FACT THAT THE ASSETS TO BE ADMINISTERED UPON IN THE BANKRUPT COURT GREATLY EXCEED THE VALUE OF THE PROVABLE CLAIMS AGAINST THE BANKRUPT, DOES NOT DEPRIVE THE ONLY CREDITORS WHO HAVE PROVABLE CLAIMS FROM ELECTING A TRUSTEE FOR THE BANKRUPT, AND ADMINISTERING UPON HIS ESTATE UNTIL THEY ARE PAID.

The proposition of law contained in the foregoing point is self-evident, but in view of the opinion of the District Court, a word or two upon its subject matter is proper.

The court below, after admitting the grave character of the question whether shareholders could be creditors, states that under the peculiar circumstance of this case "that question" need not be definitely determined at this time and continues:

> "The adjudication was had upon the petition of the corporation itself. The shareholders were named in the petition as creditors. If they are not creditors within the meaning of the bankrupt law, the corporation is not insolvent. * * * No one interested has made any objection to the adjudication and so long as it stands, based on the theory that the shareholders are creditors, they must be regarded as creditors for all purposes."

It will thus be observed that the judge of the lower court concluded inferentially, if not directly, that because the petition asserted that certain persons were creditors, the lawful creditors of the bankrupt were estopped to deny that fact. This conclusion is erroneous for several reasons.

1. In the first place, it is based primarily upon the suggestion of the court below that no person except one who is insolvent can obtain the benefit of the bankrupt act. Such is not the law. Any person, whether solvent or insolvent, may become a bankrupt voluntarily.

2. In the second place no person by alleging that certain other persons are creditors, can make them creditors as against the opposition of the real creditors. The bankrupt act provides a careful machinery for all disputes not alone between creditors of the bankrupt, but between parties who claim to be creditors of the bankrupt as between themselves.

The theory of the court below was, that as the bankrupt chose to assume in its petition that its stockholders were creditors, that not alone was it estopped to deny that fact, but that in addition

other creditors could not do so. It is evident that such a position is untenable.

3. The question of whether or not a particular person is a creditor of the bankrupt is not a question of fact but one of law. The most solemn admission of the bankrupt could not make one a creditor, who is not a creditor. Moreover, the admission here is not an admission of fact,—it is merely an allegation that certain persons occupy a certain status toward the corporation, from which the corporation admits or concludes that they are creditors. This is not the admission of a fact but a conclusion of law, in no wise binding upon anybody. For example, the petition here admits simply that certain persons are stockholders of the corporation. From this admission the petitioner concludes that these persons are creditors in a particular amount. Such an admission is valueless from any standpoint.

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## IV.

### THE DECISIONS OF THE COURTS ARE UNIFORMLY TO THE EFFECT THAT STOCKHOLDERS IN A BUILDING AND LOAN ASSOCIATION ARE NOT CREDITORS.

So far we have discussed the question involved in this case upon principle. We might well have contented ourselves by quoting from the decisions of the courts, including this court, in which, as we think, this question has been definitely decided. The insolvency of a building and loan association is *sui generis* and the only occasion when this question has

been discussed by courts at all has been in proceedings in equity in which the corporations have sought to be wound up in the interests of the stockholders.

In *Towle v. American Building & Loan Investment Co.*, 61 Fed. 448, the character of a building and loan association was fully discussed. That case was a proceeding in equity to wind up a building and loan association and Judge Grosscup said:

> "These associations are essentially corporate copartnerships. They have no function except to gather together, from small, stated contributions, sums large enough to justify loans. Their officers are the agents of every stockholder. They have no debtors or creditors except the stockholders, and whether a stockholder is creditor or debtor depends on whether he has exercised his privilege of borrowing money from the common fund. The insolvency of such an institution is *sui generis*. There can be, strictly speaking, no insolvency, for the only creditors are the stockholders by virtue of their stock. The so-called insolvency is such a condition of the affairs of the association as reduces the available and collectible funds below the level of the amount of stock already paid in. The association is said to be insolvent when it cannot pay back to its stockholders the amount of their actual contribution, dollar for dollar. The association does not deal as a corporate entity with its borrowers as strangers. The by-laws determine who become borrowers, and the officers, who are agents of such borrowers, as well as of the remaining stockholders, in the transaction, simply execute these by-laws. None of the liabilities or maxims, therefore, which apply to contracts between strangers are applicable to these transactions. The transac-

> tion of borrowing is not between strangers, or the result of contract or dealing, but is simply the execution of pre-existing rights among the stockholders. I think it plain that, when the condition of the association shows that, instead of making profits, it loses the principal of the contributing stockholders, there is power in a court of equity to wind up its affairs upon purely equitable principles. This will consist in calling in the loans, and paying out the funds thus received to the stockholders. It is not seriously disputed that on such an adjustment the borrower is under obligation to repay the actual sum received, together with interest thereon."

The same case was held in 60 Fed. 131, and at page 133 it was said:

> "The complainant is, substantially, both depositor and shareholder. Under the constitution of the society, each member passed into the treasury, periodically, certain stipulated sums. The fund thus collected is loaned out upon real estate security. The interest of the member is not that simply of a depositor in a bank, or a creditor of a corporation. He holds no promise of the corporation for a return of his fund. He is a part owner of the fund,—has an interest directly in the fund,—and is entitled to a proportionate share, as owner, upon its distribution. The whole scheme of building association is that of a corporate copartnership, whereby are gathered into a common fund, and loaned as such, the money of many individuals. The interest of each shareholder in the sums thus collected and loaned is as direct as if no corporation intervened. The corporation has no function or power, except to loan out these gathered sums, and return the avails thereof into the hands of the contributors."

This case is regarded as a leading authority by the text books and has been repeatedly affirmed by subsequent decisions of the federal courts.

See:

*Thompson, B. & L. Assn.,* pp. sec. ed. 220, 337, 339, 343, 344, 606, 607, 608;

*Manship v. New So. B. & L. Assn.,* 110 Fed. 845-862;

*Sullivan v. S.—?,* 86 Fed. 491, 493; .... ............

*MacMurray v. Gosner,* 106 Fed. 11, 12;

*Coltrane v. Balt. B. & L. Assn.,* 110 Fed. 293-96, 306, 307, 309;

*Pac. L. T. & B. v. Green,* (C. C. A.) 173 Fed. 43, 46 (9th Circuit);

*Girvin v. I. B. B. & L. Assn.,* 132 Fed. 710;

*Gunby v. Armstrong,* 133 Fed. 417, 427;

*Cooper v. Newton,* 166 Fed. 190, 196.

> "A building and loan association ordinarily does not have outside creditors as do general corporations, and unless there is a deficiency of assets there is no insolvency, in the proper sense of the word, but merely a loss of corporate capital, and consequently depreciation in value of the stock held by the member."

*Thompson, B. & L. Assns.,* §120, citing:

*Towle v. Am., etc., Soc.,* 61 Fed. 446;

*Knutson v. N. W., etc., Assn.,* 67 Minn. 201, 69 N. W. 889.

The Towle case is cited with approval, in at least one particular, by this court, in *Pacific L. T. & B. Assn. v. Green,* 123 Fed. 43, 46.

It is very plain that this language can not be reconciled with the theory contended for in the court below that these shareholders are creditors, and it is not necessary to pursue this subject further, as we shall now proceed to show that there is a direct authority controlling, as we think, upon this court on the point that shareholders of a building and loan association are not creditors.

In *Coltrane v. Blake,* 113 Fed. 785, the question was discussed as to whether the holders of paid-up stock in a building and loan association were creditors of the association, and it was held that they were not. In that case the court said:

> "Holders of paid-up stock; are they creditors of the association? In his very able report the special master discusses and exhausts this question. He holds that they remain stockholders and are not entitled to stand as creditors. 'There is nothing in any of the by-laws of the corporation which as much as suggests that the holders of paid-up stock are anything other than stockholders. They were allowed a vote at a stockholders' meetings, and many of them, including the petitioners in intervening in this cause, did vote at least by proxy. They were eligible to office, and were so elected. It is true that they received a definite dividend on their stock, and would not have been entitled to any more, no matter how great the profits of the corporation might have turned out to be. But such a contract is not uncommon between corporations and holders of certain classes of stock.' And then he quotes 1 Cook, Stock, Stockh. & Corp. Laws, Sec. 269; Hamlin v. Railroad Co., 24 C. C. A. 271, 78 Fed. 664, 36 L. R. A. 826; Mercantile Trust Co. v. Baltimore & O. R. Co., (C. C.) 82 Fed. 365. These cases sustain him.

The case last quoted was decided by the circuit court of the United States for the District of Maryland. In that case the Circuit Court (a full bench) says: 'There is a legal inference that the claim of a stockholder, with a voice in the management of the corporation, is subordinate to debts due to creditors. That this inference is a well-recognized rule of law, and that to rebut it the expression of a contrary intent, in clear and unambiguous language, is required, is shown by the following citations.' Then follows a long list of authorities. If this be the status of this paid-up stock, the holder of it comes within the rule which governs other stockholders. They cannot share the assets until all debts are paid. Plimpton v. Bigelow, 93 N. Y. 592; Fisher v. President, etc., 5 Gray 373; Gibbons v. Mahon, 136 U. S. 557, 10 Sup. Ct. 1057, 34 L. Ed. 525. And so they are neither more nor less than stockholders. The Maryland courts adopt this view also. Tax cases, 50 Md. 321. We concur with the court below in overruling the exception to the report on this point, and in adopting the conclusion of the special master.

"Are stockholders who have given notice of withdrawal creditors? The special master finds as a fact that under the by-laws of the association as amended, it is expressly declared that a withdrawal notice does not constitute a withdrawal or terminate the membership, or give to the person filing such notice the status of a creditor, or create any rights of action, legal or equitable, against the association, or in any manner alter or disturb the rights or duties as a member. This ends the case so far as those are concerned who acquired their stock after May, 1899, the date of the amendment.

"The master also finds as a fact that under the by-laws of 1891, 30 days notice was required before the stock could be withdrawn or reduced. In fact no notice of a desire to withdraw was

> given, in this case, 30 days before the appointment of a receiver in any claim proved in this case. The master discusses the question at some length, and reviews the authorities. He shows that there is a conflict of authorities upon the question whether a stockholder who has exercised his right to withdraw, and has given the notice required, and such notice has matured, can rank as a creditor. But all authorities agree that he cannot be recognized as a creditor if such notice has not matured. And this is based on reason. The condition precedent to a right to withdraw is notice for 30 days."

In this case, also, the principle involved in the question is discussed, and the court said:

> "There is another point of view. A stockholder in a corporation, by reason of his ownership of shares, has the right to participate according to the amount of his stock in the surplus profits of the corporation on a division, and ultimately, on its dissolution, in the assets remaining after payment of its debts. Plimpton v. Bigelow, 93 N. Y. 592; Gibbons v. Mahon, 136 U. S. 549, 10 Sup. Ct. 1057, 34 L. Ed. 525; Fisher v. President, etc., 5 Gray 373. So, upon the dissolution of the corporation after the debts are paid, the stockholders rank as creditors, and have a legal claim on so much of the capital stock as remains. The rule in the United States is that the capital stock of a corporation is impressed with a trust for the payment of the creditors of the corporation. Wood v. Dummer, 3 Mason, 308, Fed. Cas. No. 17,944; Sawyer v. Hoag, 17 Wall. 610, 21 L. Ed. 731. Especially is this the case with insolvent corporations. The capital stock of a building and loan association is composed of the subscriptions to it, either by cash or by dues. If

> any part of these dues is diverted from the claims of creditors generally, and is used for the benefit of a single stockholder by way of credit on a debt due by him to the corporation, it is a misuse of trust funds, and so unlawful."

Here we have the principle announced upon which stockholders are entitled to share in the assets of an insolvent corporation. This principle is the principle which governs the distribution of the assets of all corporation among its shareholders after its debts are paid. "Upon the dissolution of the corporation," *after the debts are paid,* the stockholders "rank" as creditors and have a legal claim on so much of the capital stock as remains. The reason is as there stated, that in this country the capital stock of a corporation is a "trust fund" for the benefit of its creditors. Now, if the stockholders of a corporation are creditors, as is claimed in this case, *then the capital stock is a trust fund for their benefit.* Yet it has been repeatedly held and is held in that case, specifically, so far as dues are concerned, that the diversion of any part of the capital stock to the benefit of a stockholder, is a breach of its trust relation toward its creditors. But, if such stockholders are, as is claimed, creditors, such a diversion, instead of being in violation of law, would be in full accord with the trust fund theory. If anything were needed to show that the stockholders of a building and loan association are not creditors, and have not provable claims, it is the opinion of the court of appeals in this *Coltrane* case.

In *Lewis v. Clark,* 129 Fed. 570, Judge Hawley, on appeal, speaking for this court, said:

> "The shareholders in associations of this character are not in the ordinary sense creditors and if deemed creditors in any sense they are necessarily subject to all equities existing between themselves."

The language of the Federal Supreme Court may be repeated:

A person "cannot be both creditor and debtor by virtue of his ownership of stock."

*Warren v. King,* 108 U. S. 38, 399.

No citations of further authority can be necessary. It seems to us, therefore, very clear from the foregoing that the ruling of the court below that shareholders of the corporation were creditors and as such were entitled to vote within the meaning of the Bankrupt Act, was erroneous.

Its conclusion that the Merchants National Bank was not a creditor within the meaning of the Bankrupt Act is, we think, unquestionably erroneous.

In this connection a word should be said upon the intimation made in a court below that the Merchants National Bank was a preferred creditor. Of course, the creditors of the corporation are preferred in payment to the shareholders who are distributees. *Colthane v. Blake, supra.* The authorities we have already cited on this point are conclusive. Now, the fact that a creditor of a corporation will be paid in full, and that a balance exists which will be divided in a court of equity among

the shareholders does not cause the creditor to lose his status of creditor. Yet such is the legal effect of the claim now made.

The logical result of this ruling is this: That in an instance in which the assets of the corporation are sufficient to pay the debts of the corporation in full, the stockholders alone are creditors of the bankrupt corporation and entitled to vote for trustee, while in the event that the assets of the corporation are not sufficient to pay its debts, then only the general creditors are creditors within the meaning of the Bankrupt Act who are entitled to vote. No such distinction as this can be found in the Bankrupt Act, and the error in this particular flows in part from the erroneous supposition indulged that a person can not avail himself of the Bankrupt Act unless he is actually insolvent.

It follows, therefore, that the order appealed from should be reversed, and it is accordingly so submitted.

Dated, San Francisco,
March 11, 1916.

R. P. Henshall,
*Attorney for Appellants and Petitioner.*